

RESPONSE TO PROVISIONAL DECISION REPORT

ANNEX 1: MARKET OUTCOMES

- 1 In the Provisional Decision Report (**PDR**) the CMA places weight in its AEC finding and suggested customer detriment on three quantitative analyses:
 - (a) the Fiduciary Management (FM Static and Transition) Analyses;
 - (b) a new analysis by the CMA of Greenwich Associates data; and
 - (c) the (updated) Asset Manager Product Recommendations Analysis.
- 2 This Annex contains our detailed comments on the first two of these analyses, to be read in addition to the issues explained in Section 3 above. Following a comprehensive review of each of these analyses by our advisers, we consider that the results of these analyses do not support the CMA's AEC findings. In particular, we do not believe that the CMA has identified reliable evidence of customer detriment, and the analysis is not sufficiently representative or sound to justify a market-wide mandatory tendering remedy.
- 3 The CMA has provided Mercer's advisers with access to some of the CMA's underlying analyses through a confidentiality ring. Our advisers will submit a Confidential Annex in parallel, which Mercer has not seen, providing detailed comments on the disclosed materials.
 - (a) **The Fiduciary Management (FM) analyses**
- 4 In this section, we explain why the CMA's findings in the FM "static analysis" and FM "transition analysis" are not sound and why they should not be used in support of a mandatory tendering remedy to be applied across the market.
- 5 At the outset we make three general points which apply to both analyses:
 - (a) Recent experience in 2017 and 2018 is not captured in either analysis and FM mandates acquired during 2016 are also dropped out of both analyses. These analyses therefore cover FM acquisitions from over 2.5 years ago. Levels of tendering and the use of third-party evaluators (**TPEs**) have continued to rise in recent years, meaning the analyses do not reflect important recent trends that are more relevant for understanding the current market, and predicting the future working of the market.
 - (b) The CMA uses a very narrow measure of trustee engagement. Feedback from trustees to the CMA show that schemes monitor investment consultant (**IC**) and FM performance in various ways. Yet the CMA focusses on only three measures in its analyses: formal tender; TPEs; and Professional Trustees. Further, the CMA has chosen not to consider mandates described by parties as being awarded following 'structured processes' as having been subject to a tender. ["]. This means the CMA is, at best, measuring the very lowest bound of trustee engagement, which will underestimate considerably the accurate level.
 - (c) At various points the CMA's findings are not statistically significant, yet weight is placed on them. Yet, the CMA states elsewhere in the PDR (in relation to asset manager recommendations) that a result is "*no longer statistically significant, in other words this*

[result] may be down to chance".¹ Many of the results in the FM analyses could be due to chance, and are not sufficiently robust upon which to base a market-wide remedy.

The FM Static Analysis

- 6 The CMA assesses whether FM clients in 2016 paid more in terms of implied basis points fees when internally-acquired and disengaged than when engaged. The baseline analysis is based on 198 mandates from 2016.

(i) STATA coding issues result in misclassifications

- 7 Our advisors can identify ["] mandates that were incorrectly classified by the CMA as 'disengaged' but exhibit one of the CMA's three measures. This is due to a STATA error – a typo in the CMA's analytical code.
- 8 Correctly classifying these mandates shows there to be **no statistically significant difference** in the FM fees paid by 'engaged' and 'disengaged' clients in the CMA's baseline regression (indeed, the sign of the estimated coefficient on the CMA's baseline engagement variable changes from negative to positive).
- 9 There are also other classification-related issues. ["]. Reclassifying these mandates as engaged further weakens the CMA's findings.

(ii) The CMA's sample is skewed and not representative of the market

- 10 The CMA focusses its analysis on the five integrated IC-FM firms only, although it collected data from a wider number of firms. The baseline sample, however, uses data from only four firms. This data cleaning means that one of the large IC-FM firms (a different firm from that removed in the transition analysis) is entirely removed from the analysis.
- 11 Over 60% of the CMA's sample of 198 is accounted for by one firm.² It alone has more mandates than formed the basis for the CMA's baseline in the transition analysis. When the regression is tested on the 120 mandates of this one firm, no statistically significant result is found.
- 12 In terms of 2016 FM revenues, the sample of 198 mandates covers only between 29% and 38% of the market.
- 13 Given the skew to one firm and the small coverage in terms of revenues, the analysis is not representative of the market at a whole.

(iii) The CMA's finding is not robust to small changes in the specification

- 14 The statistical significance of the finding can be removed with small changes in the static analysis regression specification. For example, the CMA includes in its baseline the variable "Percent assets in FM". The coefficient of the variable is zero and not statistically significant in the baseline in all but one of the models shown by the CMA (Table 26). When this variable is removed from the specification, however, the statistical significance of the main result on engagement disappears and the coefficient shrinks, with both the sample size and adjusted R-squared rising. Including this apparently unnecessary variable in the baseline distorts the CMA's findings.

¹ PDR, paragraph 10.81. See also paragraph 112, page A2.27, where the CMA explains in relation to AM product recommendations that "[t]he absence of statistical significance implies that the observed *[result]* may be entirely due to chance".

² In terms of revenues, the one firm comprises 44% of the sample.

(iv) *The CMA's finding is not generalisable to the whole market*

- 15 We have noted that the result of the FM static analysis is based on a small, skewed sample. Correcting a STATA error removes the statistical significance of the PDR's headline result on the effect of the three narrow measures of engagement on fees (and indeed the sign on the estimated coefficient becomes positive). There is therefore no reliable evidence of detriment.
- 16 However, even if it were true that "*internally acquired & disengaged*" clients pay more than "*internally acquired & engaged*" clients at these integrated IC-FM firms, this would not mean there is significant customer detriment.
- 17 The CMA's own analysis (both in averages and medians) shows that "*internally acquired & disengaged*" clients do not pay significantly more than "*all externally acquired*" clients. The coefficient on "*all externally acquired*" is not statistically significant in any regression specification presented. The internally-acquired & disengaged clients are not getting a worse deal in terms of FM fees than those clients that have undertaken wider market engagement or switching.
- 18 According to the CMA's evidence, only the firms that tender and stay with their existing IC provider benefit in terms of lower FM fees. The outcome for those that tender and switch is less clear. This shows that tendering is not unambiguously beneficial, with no evidence at the market level that those who tender get lower prices than those that do not. This raises concerns about any mandatory tendering regime justified on the grounds of potential fee savings.
- 19 The CMA appears to overstate materially the importance of its FM static finding in the customer detriment calculation in Chapter 11 of the PDR. At paragraph 11.15 of the PDR, the CMA incorrectly states: "*As a result of these competition problems, customers may be expected to pay higher prices for investment consultancy and fiduciary management than they otherwise would. The existence and significance of these price effects is demonstrated by our gains from engagement analysis, which found that engaged fiduciary management customers could pay around 24% less than disengaged customers*" (emphasis added). This is not accurate - it is not a market outcome. The FM static analysis result is much more limited in scope, reflecting only the outcomes for the small subset of FM clients within the integrated firms that chose to stay with their existing IC provider.
- 20 This result is then generalised further in paragraph 11.16, where it is stated that: "*In terms of the total detriment from higher prices, by way of illustration, even if fees are on average only 10% above those in a well-functioning market, this would in aggregate lead to investment consultancy customers paying around £250 million and fiduciary management customers paying around £200 million more over ten years.*" The FM static analysis does not show that fees in FM across the whole market are 10% higher than some, undefined well-functioning level. The only analysis that could have shown this was the economic profitability analysis, and the CMA has no evidence that profits are excessive.

The FM Transition Analysis

- 21 The CMA assesses whether clients transferring from IC to FM within the same firm see a higher increase in fees if they are engaged or not. The baseline analysis focusses on the experience of a sample 104 clients transitioning between 2011 and 2016.
- 22 We comment below on the transition analysis presented in the PDR. However, in the confidentiality ring, several material STATA code errors have been found. When these are corrected, the findings of the CMA analysis lose their statistical significance in the baseline analysis.

(i) *The CMA's sample is skewed and not representative of the market*

- 23 The CMA has stated that the analysis examines the experience of five integrated IC-FM firms, but this is incorrect. Data cleaning has meant that one of the large IC-FM firms is entirely removed from the analysis.
- 24 Over 85% of the CMA's sample of 104 clients arise from just two firms, with the other two firms contributing just 13 clients in total. In 2016 revenue terms, the two firms comprise just under 80% of the sample.
- 25 As noted above, in terms of total 2016 FM revenues the sample covers just 9-11% of the market. Further, when eight 'externally-acquired' clients – incorrectly included in the sample due to a STATA issue – the analysis covers even less of the market.

(ii) *One firm drives the CMA's finding*

- 26 As noted above, the CMA's sample is skewed to two firms. Removing one of these firms from the regression removes the statistical significance of the CMA's findings and, in fact, improves the model's adjusted R-squared.
- 27 When testing this firm on its own, there is evidence of a statistically significant fee differential between engaged and less-engaged mandates. The CMA's result appears to be substantially driven by this one firm.
- 28 The CMA's result is therefore not a 'market' outcome: it is the impact of one firm.

(iii) *The CMA's result is not robust to important sensitivity checks*

- 29 We have noted previously that the statistical significance of the CMA's findings falls away under two important sensitivities:
- (a) Restricting the sample to those schemes "Buying 2+ IC services only" (of the, at least, five services available). This suggests that the baseline transition results are being driven by schemes with very limited usage of IC services before transitioning to FM.
 - (b) Restricting the sample to "Full FM only" schemes. On this important subset, the effect of engagement is not statistically significant.
- 30 However, there are additional important sensitivities now visible through the confidentiality ring that show the finding is not robust (results are reported in detail in the Confidential Annex):
- (a) As noted above, removing one firm removes the statistical significance of the result.
 - (b) The findings weaken when excluding eight 'externally acquired' mandates that incorrectly have been included in the analysis.
 - (c) The CMA's own STATA code shows it tested, but did not publish in its Working Paper or PDR, a sensitivity analysis where a different metric of the FM-to-IC spend variable was constructed.³ Under this unreported sensitivity there was no statistical significance.
 - (d) The CMA's result depends on the specification of the FM-to-IC spend ratio rather than the level of engagement. The illustration below shows how the CMA computes the IC-to-FM ratio. It constructs the metric by averaging IC revenues in all years preceding the transition (dropping the transition year) and comparing this to the average of all FM

³ See ["].

revenues in all years after transition. This ratio is vulnerable to events that are unrelated to the transition itself e.g. to improving AUM during the years after transition.⁴ If a more intuitive ratio is used – the spend in the year just before and just after the transition (i.e. more directly connected to the transition) – then the finding is again not statistically significant even though the sample size, in fact, increases.

Illustration of calculation of FM-to-IC spend ratios

	2011	2012	2013	2014	2015	2016
Hypothetical flow of revenues	AR1	AR2	AR3	FR1	FR2	FR3
CMA's spend ratio	AR1	AR2	AR3		FR2	FR3
Short-term spend ratio			AR3		FR2	

	Advisory revenue	Average revenue
	Fiduciary revenue	No revenue

(b) Analysis by the CMA of Greenwich Associates data

- 31 In the PDR, the CMA presents an analysis attempting to show that in the IC market there is a negative association between perceived quality – based on the Greenwich Associates Quality Index (**GQI**) – and market share.
- 32 The CMA had not previously consulted on either the approach to this analysis or any provisional results. However, we believe the CMA's analysis is flawed and its results should be disregarded.
- (i) *The CMA uses incorrect market share data*
- 33 The CMA says it used its own market share data (from Chapter 4) in the analysis.⁵ Access to the data in the confidentiality ring shows this is incorrect.
- 34 In Figure 5 of Chapter 4, the largest FM firm has a share of 16%. In the GQI analysis, the largest firm has a share of 21%; over five percentage points higher than in Chapter 4.
- 35 Similarly, the three-firm concentration ratio in Chapter 4 is 41%, but in the GQI analysis is 52%, a difference of over 10 percentage points.
- 36 In our view, the use of inconsistent market share data invalidates the results presented in the PDR. Further, the use of data that artificially overstates the concentration of the market (particularly the presence of larger, established firms) and understates the influence of other firms creates a bias that will mechanically dampen any effects of quality on market share.
- (ii) *The CMA model with firm fixed effects shows no effect*
- 37 The CMA presents its regression results in Table 38 (reproduced below). The baseline model does not account for firm fixed effects. When the CMA includes firm fixed effects, highlighted in column (5), the coefficient and statistical significance disappear (and the p-value rises materially).

⁴ Under the CMA's construction, a scheme would face a higher FM-to-IC spend ratio if the fiduciary manager was able to grow the scheme's AUM over time, in effect penalising the fiduciary manager for its success.

⁵ See paragraph 10.104.

- 38 Including firm fixed effects is an important control, as is reflected by the CMA in its IC static analysis. In that analysis (of the same IC firms as included here), the CMA considered that including firm fixed effects was advantageous to control for unobservable differences between the firms and the inclusion of firm fixed effects was a key reason why the CMA ultimately softened its conclusions in that analysis.⁶ The inclusion of firm fixed effects also makes intuitive sense in this GA quality analysis given the recognised differences between investment consulting firms (e.g. in pricing, complexity of client assignments, strategy, etc.) that could explain market share movements.
- 39 Including the firm fixed effects removes the CMA's finding. The finding is still, however, based on the flawed market share data described above.

 Table 38: Regression Results: Quality and Market shares.³⁰⁹

	(1)	(2)	(3)	(4)	(5)	(6)	(7)
	Baseline	Log MS	Log MS, Log Quality	Quality in Ranks	Firm FEs	ΔMS	ΔMS, ΔQuality
Quality	-0.04* (0.08)	-0.01** (0.03)	-3.08* (0.05)	-0.92* (0.06)	-0.00 (0.85)	0.00 (0.23)	0.00 (0.83)
Year fixed effects	YES	YES	YES	YES	YES	YES	YES
Constant	29.55* (0.05)	4.65** (0.01)	20.58** (0.04)	14.11** (0.03)	8.30*** (0.00)	-1.31* (0.07)	-0.11 (0.71)
Observations	85	85	85	85	85	85	70
Adjusted R-squared	0.051	0.081	0.059	0.095	-0.075	-0.068	-0.094

p-values in parentheses * p<0.10 ** p<0.05 *** p<0.01

(iii) The GQI measure of quality ["]

- 40 ["].
- 41 ["].⁷
- 42 ["].⁸
- 43 Third, given the small sample sizes and subjective questions, the non-linear weighting scale used in the GQI creates further uncertainty.⁹ A GQI quality score could move substantially year on year based on a single respondent changing its responses from 5 to 4.
- 44 Finally, the CMA explains that the GQI score is constructed by summarising the survey responses into a single score and then "[t]his score is normalised and transformed to a scale from 0 to 1,000, with a mean score of 500 and a standard deviation of 166.7". The data in the confidentiality ring shows that 80 of the 85 GQI observations are within one standard deviation of the population mean. Not one observation is different from the population mean to a statistically significant extent (e.g. 90% confidence level). Any difference from average could be "*entirely due to chance*".
- 45 ["].

⁶ The CMA explains: "Including these fixed effects may be advantageous because it allows us to control for any scheme-variant but provider-invariant drivers of quality, even if these are unobservable. That is, provided we can assume that the true level of engagement is no higher or lower at different providers, including provider fixed effects allows us to more fully control for confounding factors." (paragraph 88, page A5.25).

⁷ ["].

⁸ ["].

⁹ Greenwich Associates uses a Likert scale in a non-linear way with "Excellent" or 5 is assigned as 100, 4 as 50, 3 as 25, 2 as 12.5, and "Poor" or 1 as 0.

(iv) Further uncertainty is introduced by missing data

- 46 The CMA's analysis focusses on 15 firms with a combined market share of under 85% in 2016, meaning more than 15% of the market is missing from the analysis. In several years, more than 10% of the market is missing from the analysis. Smaller firms being omitted are also those that, on average, are growing market share.
- 47 The combined share of the larger ICs falls significantly over the period, as for example illustrated by the very rapid fall in market HHI of around 700 points between 2010 (HHI of 1,840) and 2016 (HHI of around 1,117).

(v) The CMA models have poor fit

- 48 The CMA presents the results of its regressions in Table 38. The adjusted R-squared values shown are extremely low, with the models explaining less than 10% of the variation in the data. For three of the models, the adjusted R-Squared is negative. This implies that the average market share over the period 2011-2016 would be a better predictor of market share variation than GQI.